Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
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	)	
	)	CC Docket No. 96-45
Federal-State Joint Board on Universal Service	)	
	)	FCC 04J-2
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COMMENTS OF THE INDEPENDENT TELEPHONE AND TELECOMMUNICATIONS ALLIANCE

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Summary

In this proceeding, the Federal-State Joint Board ("Joint Board") seeks comment on whether to change the rural high-cost support mechanisms to better serve the goals of the Telecommunications Act of 1996. As the Independent Telephone and Telecommunications Alliance ("ITTA") explains herein, the current system for calculating incumbent local exchange carrier ("ILEC") support should not be changed at this time. ILEC support should continue to be based on the actual costs of providing service in high-cost areas. Any recommendations by the Joint Board to alter the current mechanism for calculating ILEC support could have devastating consequences on investment in rural areas.

There are two areas in which ITTA recommends changes to the current high-cost support system. First, ITTA maintains that the most effective way to better target rural high-cost support is to calculate support for competitive eligible telecommunications carriers ("CETCs") based on their own costs -- not the ILEC's. Second, Section 54.305(a) and the safety valve mechanism are inadequate to encourage investment in rural high-cost areas. Specifically, Section 54.305(a) of the Commission's rules should be eliminated, and the safety valve mechanism should be modified such that acquiring carriers may receive support for investments made in the first year post-acquisition.

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THE INDEPENDENT TELEPHONE AND TELECOMMUNICATIONS ALLIANCE

The Independent Telephone and Telecommunications Alliance ("ITTA"), through its attorneys, hereby offers the following Comments in response to the Federal Communications Commission's ("FCC" or "Commission") Public Notice seeking comment on behalf of the Federal-State Joint Board ("Joint Board") in the above-referenced proceeding.[1]

I. INTRODUCTION AND SUMMARY

ITTA is an organization of midsize incumbent local exchange carriers ("ILECs") that collectively serve over ten million access lines in over 40 states and offer a diversified range of services to their customers. Most members qualify as rural telephone companies within the meaning of Section 3(37) of the Communications Act of 1934, as amended (the "Act").[2]

The Joint Board seeks comment on whether to change the rural high-cost support mechanisms to more efficiently and effectively serve the goals of the Telecommunications Act

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1 *Federal-State Joint Board on Universal Service Seeks Comment on Certain of the Commission's Rules Relating to High-Cost Universal Service Support*, Public Notice in CC Docket 96-45, FCC 04J-2 (rel. Aug. 16, 2004) ("Public Notice").

2 47 U.S.C. §153(37).

of 1996.[3] In particular, the Joint Board is looking at all aspects of the Commission's rules to see if changes would (i) better target support to the highest-cost areas, (ii) encourage investment, innovation and entry in those areas, and (iii) control growth of the fund.[4] This inquiry impacts the calculation of support for both ILECs and competitive local exchange carriers ("CLECs").[5] The Public Notice is replete with references to improving "efficiency" in the high-cost funding mechanism. Scant attention is given to proposals for making certain that support remains "specific, predictable, and sufficient" to ensure rates and services in rural areas remain comparable to those in non-rural areas.

ITTA maintains that the current system for calculating ILEC support based on actual costs generally is far more effective at achieving the Act's goals than any of the modifications proposed in the Public Notice would be. ITTA urges the Joint Board not to recommend any changes at this time to the manner in which ILEC support is calculated. Calculating support based on the actual costs of a rural carrier's existing network design is efficient, and most importantly, it satisfies the statutory principles that support mechanisms be specific, predictable, and sufficient. Moreover, in light of other proposed changes in cost recovery by ILECs, any significant modifications to the calculation or distortion of ILEC high-cost support could have a devastating impact on investment in rural areas.

One area where the current rules depart from cost-based principles is in the case of acquisitions. ITTA supports modifications to the Commission's rules that will ensure that carriers acquiring access lines are not penalized for investing in rural high-cost areas. Finally,

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3 Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56 ("1996 Act").

4 Public Notice at ¶¶ 6, 21, 38, and 45.

5 *Id.* at ¶30.

ITTA continues to support revisions to the method for calculating support for competitive eligible telecommunications carriers ("CETCs") such that they receive support based on their own costs--not the ILEC's. This is the best way to better target rural high-cost support to areas where it is truly needed, create rational economic incentives for investment (and eliminate disincentives under the current system), achieve greater efficiencies, and better control growth in the fund.

II. THE JOINT BOARD MUST ACKNOWLEDGE THE UNIQUE NATURE OF RURAL MARKETS AS IT EVALUATES WHETHER TO RECOMMEND ANY CHANGES TO RURAL HIGH-COST MECHANISMS.

A. Rural Markets are Highly Diverse and Face Unique Operating Challenges.

The Commission and the Joint Board consistently have recognized the unique characteristics of rural high-cost markets, which differ greatly from more urbanized areas. Compared to the larger ILECs, rural carriers generally serve smaller subscriber bases which are comprised of people who live in more sparsely populated areas.[6] Rural carriers serve fewer than twelve percent of the nation's access lines,[7] 38% of the nation's land area, and 93% of the study areas.[8] While the average population density for areas served by non-rural carriers was 105 people per square mile, the average population density for areas served by rural carriers is merely 13 people per square mile.[9]

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6 *In the Matter of Federal-State Joint Board on Universal Service*, Recommended Decision, FCC 00J-4, 16 FCC Rcd 6153 (rel. Dec. 22, 2000) ("*Rural Task Force Recommendation*") at A-11.

7 *In the Matter of Federal-State Joint Board on Universal Service*, Order on Remand, Further Notice of Proposed Rulemaking, and Memorandum Opinion and Order, 18 FCC Rcd 22559, 22559 n.1 (2003) ("*Non-Rural High Cost Modification Order*").

8 *Rural Task Force Recommendation*, 16 FCC Rcd at A-11.

9 *Id.*

Not only do the markets served by rural carriers differ significantly from non-rural markets, but wide variability exists *among* rural markets as well. The number of lines served by individual rural carriers varies, and the range of their costs is expansive. For example, among ITTA members, ALLTEL's smallest study area, ALLTEL New York – Red Jacket, has fewer than 2,800 lines, while CenturyTel's study areas range in size from tiny CenturyTel of Chester, Iowa, with 221 lines, up to CenturyTel of Washington, with approximately 180,000 lines. TDS's study areas range from just over 100 lines (Asotin Telephone Company, Oregon) to approximately 64,000 (Tennessee Telephone Company).[10] With respect to investment-related costs, wide variability exists as well. The gross investment in central office switching equipment ranges from very small amounts to as much as $9,191 per loop.[11] Loop costs also vary widely among rural carriers, with the range in expense per loop spanning between $4 and $1,585.[12]

Rural carriers face significant operating challenges in serving their diverse customer bases that set them apart from non-rural carriers. For example, rural carriers have relatively higher loop costs than non-rural carriers because rural carriers tend to serve more geographically remote areas.[13] Total investment in plant per loop and plant specific and operations expenses also significantly exceed those of non-rural carriers.[14] In addition, because

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10 *See* Universal Service Administrative Company, High Cost Loop Support Projected by State by Study Area, 2Q 2004, available at http://www.universalservice.org/overview/filings (last visited Oct. 4, 2004). See also Monitoring Report, CC Docket No. 98-202, (rel. Oct. 2001) at Table 3.27 (all statistics).

11 Rural Task Force, *The Rural Difference*, White Paper #2 (Jan. 2000) ("*Rural Task Force White Paper #2*") at 50.

12 *Id.* at 54.

13 *Rural Task Force Recommendation*, 16 FCC Rcd at A-12.

14 *Id.*

rural carrier switches serve fewer customers, they have fewer people over which to spread the network's high fixed costs.[15] The average household income for customers of rural carriers is lower than in non-rural areas.[16] Without sufficient support, these higher network costs would have to be borne by people who can least afford it. Yet rural carriers rely on high-quality telecommunications services even more than their urban counterparts.[17] In order to provide high-quality, advanced telecommunications service to rural customers at affordable rates, rural carriers rely heavily upon federal and state universal service support. Universal service support, therefore, makes up a greater percentage of a rural carrier's revenue base.[18] Any dramatic changes to the amount of support these carriers receive could adversely affect their ability to provide vital services to customers in rural areas.

The challenges of serving rural markets is exacerbated by the current instability of the federal universal service fund, much of which can be attributed to the ever increasing number of CETCs seeking universal service support.[19] The impact that the increasing number of CETCs

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15 *Id.* at A-13.

16 *Id.* A-14; *In the Matter of Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans*, Fourth Report, FCC 04-208, GN Docket No. 04-54 at 32 (rel. Sept. 9, 2004) ("*Section 706 Report*").

17 *Id.* at 8-9. *See also* NECA's 2003 Access Market Survey, "*Fulfulling the Digital Dream,*" available at http://www.neca.org/media/2003AMS.pdf (last visited on Oct. 13, 2004) at 9 (summarizing the enormous technological advances among rural telephone companies) ("*NECA Survey*").

18 *Rural Task Force Recommendation*, 16 FCC Rcd at 6154-55 ¶4.

19 *See* http://www.universalservice.org/hc/whatsnew/072004.asp#072704 (last visited on Oct. 4, 2004) (showing that the number of CETCs receiving high-cost support has climbed from 23 in 2001 to 142 in 2004; also showing that distribution of high-cost support to CETCs has grown from .78% in 2001 to 7.06% in 2Q 2004).

has had on the fund recently has drawn the attention of members of Congress.[20] Commissioners and Joint Board Members Abernathy and Martin also have expressed concern about the growth of the fund and have urged the Commission and the Joint Board to take action.[21] ITTA supports revisions to the manner in which CETC support is calculated and believes that reform in this area is the single most effective way to manage growth in the fund.[22]

As noted above, rural customers are uniquely dependent on the availability of high-quality telecommunications capability, and disproportionately rely on universal service support to ensure that availability. As the Joint Board contemplates changes to the high-cost mechanism, ITTA urges it to remain mindful of the unique operating challenges facing rural carriers and the vital role that sufficient support plays in their ability to provide quality telecommunications services to rural America.

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20 Hearing of the Communications Subcommittee of the Senate Committee on Commerce, Science and Transportation, *The Future of Universal Service*, Federal News Service, April 2, 2003 (where Senator Conrad Burns recognized that universal service reform is "a matter of urgency" and that "action is necessary to help out our high-cost areas and ensure telecommunications for everybody in the United States").

21 Written Statement of Kathleen Q. Abernathy, Commissioner, Federal Communications Commission, on Preserving and Advancing Universal Service, Before the United States Senate Committee on Commerce, Science and Transportation, Subcommittee on Communications, at 3 (Apr. 2, 2003) (noting the rapid growth of CETC funding and the need for the present review); Remarks by Kevin J. Martin, Federal Communications Commission, to the Santa Fe Conference of the Center for Public Utilities Advisory Council, Santa Fe, New Mexico, March 18, 2003, at 6-7 (commenting on the jump in funding to CETCs and stating that "without quick action by the Joint Board and the Commission . . . pressure on the fund will only increase").

22 *See infra* discussion in Section VI.

B. The High-Cost Model Mechanism Adopted for Non-Rural Carriers is not Appropriate for Rural Carriers.

The differences between rural and non-rural carriers make it problematic to apply the high-cost support mechanism adopted for non-rural carriers to rural carriers.[23] Recognizing that rural carriers often cannot respond to changes in operating circumstances as quickly as large carriers, the FCC has concluded in the past that the universal service support mechanisms for rural carriers should differ from those for non-rural carriers at least on an interim basis.[24] In fact, this rationale served as the basis for the Commission to decline *twice* to adopt immediately a forward-looking economic cost model for rural carriers.[25]

The FCC has refused to apply a regulatory structure adopted for larger carriers to smaller carriers in other contexts as well. In the early nineties, for example, the Commission declined to make price cap regulation mandatory for any carriers outside of the Bell Operating Companies ("BOCs") and GTE.[26] More recently both Congress and the FCC have recognized that carriers with fewer than two percent of the nation's access lines -- measured at the holding

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23 *See* Public Notice at ¶¶28-32 (seeking comment on the application of the synthesis model to rural carriers).

24 *In the Matter of Federal-State Joint Board on Universal Service*, Report and Order, 12 FCC Rcd 8776, 8934 ¶291 ("*First Universal Service Report and Order*").

25 *Id.*; *In the Matter of Federal-State Joint Board on Universal Service, Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, Fourteenth Report and Order, Twenty-Second Order on Reconsideration, and Further Notice of Proposed Rulemaking in CC Docket No. 96-45, and Report and Order in CC Docket No. 00-256, 16 FCC Rcd 11244, 11256 ¶25 (2001) ("*RTF Order*"), as corrected by *Errata*, CC Docket Nos. 96-45, 00-256 (Acc. Pol. Div. rel. Jun. 1, 2001), *recon. pending*.

26 *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, 6818, ¶¶257-265 (1990) ("*LEC Price Cap Order*"), *aff'd sub nom. National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

company level -- deserve different regulatory treatment from larger carriers.[27] In light of the significant differences between rural and non-rural carriers, ITTA urges the Joint Board to keep in mind that "one size" does *not* "fit all" when considering the appropriate universal service mechanism for rural carriers. As the FCC has concluded in the past, the high-cost model for non-rural carriers simply is not appropriate for rural carriers and the customers they serve.[28]

C. The Existing Rural High-Cost Mechanism has been Successful in Achieving Efficiencies and Flowing Them Through the Support System.

Chairman of the state Joint Board member Bob Rowe recently stated that one of the great successes of recent telecommunications policy is the deployment of high-quality telecommunications services to rural America, particularly those areas served by rural telephone companies.[29] ITTA believes that much of this success can be attributed to the recognition that it would be inappropriate to apply the high-cost model used for non-rural carriers to rural carriers at this time.[30]

Federal universal service programs have assisted in the nearly ubiquitous deployment of telecommunications service to rural areas. The current penetration rate is

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27 *See* 47 U.S.C. §251(f)(2) (permitting two percent carriers to petition their respective state regulatory commissions for exemption from certain requirements of Section 251); *see also In the Matters of 1998 Biennial Regulatory Review -- Review of ARMIS Reporting Requirements; Petition for Forbearance of the Independent Telephone and Telecommunications Alliance*, Report and Order in CC Docket No. 98-117, Fifth Memorandum Opinion and Order in AAD File No. 98-43, 14 FCC Rcd 11443, 11461 ¶31 (streamlining the ARMIS reporting requirements for certain mid-sized ILECs).

28 *RTF Order*, 16 FCC Rcd at 11247 ¶4; *see also Rural Task Force Recommendation*, 16 FCC Rcd at A-14 (stating that "a 'one-size-fits-all' national universal service policy is unlikely to be successful in fulfilling the national universal service principles contained in the [Telecommunications Act of 1996])."

29 Statement of Chairman Bob Rowe, FCC 04J-2 (rel. Aug. 16, 2004).

30 *See RTF Order*, 16 FCC Rcd at 11247 ¶4.

approximately 95%.[31] In addition to establishing a cost-based support system for rural carriers that has been successfully implemented, the *RTF Order* also helped to facilitate additional competitive entry into high-cost areas by allowing rural carriers to disaggregate and target support.[32] Under the *CALLS Order*, the FCC also reduced and made explicit subsidies by permitting a greater proportion of the local loop costs to be recovered through the subscriber line charge ("SLC") and deaveraging SLCs after the carrier common line charge ("CCL") and multi-line business primary interexchange carrier charges ("PICCs") were eliminated.[33]

As a result of these reforms, federal rural high-cost support is explicit, specific, predictable, and sufficient, consistent with the mandate of Section 254 of the Act.[34] These initiatives also have helped to ensure that basic local service rates in rural and high-cost areas are reasonably comparable to those in urban areas.[35] The Joint Board should avoid making any recommendations that would turn back the clock on these significant achievements.

D. The Joint Board Should not Make any Recommendations that will Reduce Support to Rural High-Cost Areas.

ITTA cautions the Joint Board against making any recommendations that could threaten support to rural high-cost areas. Since 1997, the FCC has "allow[ed] ample time for

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31 *See* Federal State Joint Board Universal Service 2004 Monitoring Report, Section 6, CC Docket No. 98-202 (rel. Oct. 4, 2004).

32 *RTF Order*, 16 FCC Rcd at 11302-09 ¶¶57-65.

33 *In the Matter of Access Charge Reform; Price Cap Performance Review for Local Exchange Carriers; Low-Volume Long Distance Users; Federal-State Joint Board on Universal Service*, Sixth Report and Order in CC Docket Nos. 96-262 and 94-1, Report and Order in CC Docket No. 99-249; Eleventh Report and Order in CC Docket No. 96-45, 15 FCC Rcd 12962, 12972, 12974 ¶¶ 25, 29 (2000) ("*CALLS Order*").

34 *See* 47 U.S.C. § 254(b)(3), (5); *Non-Rural High Cost Modification Order*, 18 FCC Rcd at 22621-22 ¶105.

35 *Id.*

rural carriers to adjust to any changes in support calculations."[36] ITTA urges that now, more than ever, a cautious approach is needed.[37]

Calculating support based on forward-looking costs, for example, could have devastating consequences in rural areas because insufficient support would discourage rural investment. When the BOCs were faced with similar circumstances, they neglected their rural exchanges to respond to competitive pressures. The BOCs sold many of their rural properties rather than support them with revenues from larger urban markets.[38] Today, some parties are urging that rural LECs be made even more dependent on universal service support by eliminating all access charges.[39] Caps on the rural high-cost fund and competitive pressures also impinge on rural ILECs' ability to maintain current investment levels. Universal service policies must ensure that rural carriers receive sufficient support to serve their customers. Any changes to the rural high-cost support mechanism should be grounded with an understanding of the consumers who would be affected, how reductions in support in these areas could result in diminished levels of service, and how customers and communities could be harmed.[40]

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36 *RTF Order*, 16 FCC Rcd at 11247 ¶4; *First Universal Service Report and Order*, 12 FCC Rcd at 8934 ¶291.

37 As noted above, the current instability of the federal universal service fund threatens rural carriers' ability to continue providing high-quality services to rural markets. *See infra* discussion in Section II.A. In the meantime, access revenues continue to decline due to a decrease in the number of access lines served by the LECs and the minutes of interstate usage of the wireline network. At the same time, the Commission has before it bill and keep proposals to replace the current access charge regime.

38 *Reshaping Rural Telephone Markets: Financial Perspectives on Integrating Acquired Access Lines*, Legg Mason Telecom (Fall 2001) at 130-32.

39 Letter from Richard Cameron of Latham & Watkins to Marlene H. Dortch, Secretary, Federal Communications Commission, dated Oct. 5, 2004 ("*ICF Plan*").

40 *See supra* discussion in Section II.A.

III. ACTUAL COSTS ARE THE APPROPRIATE BASIS FOR CALCULATING ILEC SUPPORT.

A. Section 254 of the Act Requires that Universal Service Support Mechanisms be Specific, Predictable, and Sufficient -- not Efficient.

Section 254(b) of the Act sets forth the principles that govern federal universal service policies. Specifically, Section 254(b) requires that support mechanisms be specific, predictable, and sufficient to preserve and advance universal service.[41] In addition, federal universal service policies must ensure that consumers in rural, insular, and high-cost areas have access to telecommunications and information services that are reasonably comparable to those services provided in urban areas and at reasonably comparable rates. Consistent with Congress' mandate, the chief and overarching goal of this proceeding should be for the Commission to ensure that rural high-cost support mechanisms are specific, predictable, and sufficient.[42]

1. *Efficiency is not a statutory goal.*

Efficiency is not a policy objective of Section 254. Yet, the Public Notice asks numerous questions about how the rural high-cost support mechanisms can best encourage rural carriers to achieve greater efficiencies and economies of scale. The Joint Board seeks comment, for example, on whether a forward-looking economic cost model and other changes in the Commission's rules would more efficiently achieve the 1996 Act's goals,[43] create proper

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[41] 47 U.S.C. §254(b).

[42] 47 U.S.C. §254(b)(3), (5).

[43] Public Notice at ¶¶1, 21.

incentives for rural carrier investment and efficiency,[44] and encourage rural carriers to provide services more efficiently.[45]

Although "efficiency" generally may be a worthy public policy goal when all other statutory goals are satisfied, the Act contains no specific reference to efficiency as a guiding principle for establishing federal universal service policies. Neither the concept of efficiency nor the word itself appears in the statute. Moreover, the FCC did not identify efficiency as an additional principle for universal service, pursuant to Section 254(b)(7) of the Act,[46] or establish efficiency as superior to the explicit goals of the Act. The Joint Board's use of "efficiency" as a guiding principle ignores the proper statutory framework for this proceeding, which is to ensure specific, predictable, and sufficient support for rural high-cost areas in the future.

2. *Support must be sufficient.*

The statute requires that universal service support mechanisms be "sufficient" rather than "efficient." These two principles are fundamentally different. Although sufficiency must be interpreted in the context of cost recovery, efficiency as a concept implies no such normative framework. Efficiency presumes to minimize support without reference to cost recovery.

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44 *Id.* at ¶¶24, 26, 33, 38.

45 *Id.* at ¶¶16, 46.

46 47 U.S.C. §254(b)(7).

As Professor Dale Lehman of the Alaska Pacific University points out, "economic efficiency does not necessarily result in universal service."[47] Although competition generally leads to economic efficiency by setting prices equal to the minimum costs of production, competition does not guarantee universal telephone service.[48] In fact, if competition led to universal service in rural high-cost areas, there would have been no need for Congress to enact Section 254 in the first instance. The FCC and the Rural Task Force have repeatedly recognized that universal service goals could not be achieved without sufficient support to stimulate investment in rural areas.[49] Sufficiency is the proper goal of this proceeding.

3. *Support must be specific and predictable.*

Section 254 of the Act also requires that support be "specific" and "predictable."[50] To ensure that support satisfies the statute's objectives, a carrier should receive support based on that carrier's unique costs of serving a particular market. The statutory principle of sufficiency requires that support not be based on a hypothetical model nor be based on a general assessment of rural carrier costs nationwide. Rather, support should be specific to the carrier's costs and the

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47 Dale Lehman, *Universal Service and the Myth of the Level Playing Field* (Aug. 12, 2003) at 3-11.

48 *Id.* at 5.

49 *In the Matter of Multi-Association Group (MAG) Plan for Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers and Interexchange Carriers*, Second Report and Order and Further Notice of Proposed Rulemaking in CC Docket No. 00-256, Fifteenth Report and Order in CC Docket No. 96-45, and Report and Order in CC Docket Nos. 98-77 and 98-166, 16 FCC Rcd 19613, 19705 ¶220 (2001) ("*MAG Order*"); *RTF Order*, 16 FCC Rcd at 11264, 11282, 11288 ¶¶ 42, 93, 107; Rural Task Force, *Mission and Purpose*, White Paper #1 (Sept. 1999) at 5; *see also NECA Survey* at 7 (stating that high rural equipment costs severely limit the bandwidth available for high speed advanced communications).

50 47 U.S.C. §254 (b)(5).

market that carrier serves, and predictable enough that the carrier can make rational investment decisions and honor its commitments in high-cost markets.

Although the record in the RTF proceeding did not specify a point at which support should be set, the Commission sought to make rural high-cost support "more *specific* to the needs of rural carriers" than the non-rural high-cost model would have been.[51] Rural carriers must continue to be assured a specific and predictable level of support if they are to continue providing supported services to rural customers at affordable rates.[52]

B. <u>While Efficiency is not a Goal of the Act, the Current System is Nonetheless Already "Efficient."</u>

The rural high-cost support system already is largely successful in ensuring that explicit support mechanisms are specific, predictable, and sufficient.[53] As discussed in greater detail below,[54] the changes proposed in the Public Notice fail to recognize the efficiencies realized by the current system.

1. *The existing cost-based system is efficient.*

Although efficiency is not the primary goal of Section 254, certain efficiencies already are realized under the current rules. Ironically, the proposed changes would create greater *inefficiencies* by promoting divestiture of rural study areas and creating new implicit subsidies, and could result in higher universal service payments.

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51 *RTF Order*, 16 FCC Rcd at 11262 ¶39 (emphasis added).

52 *Id.* at 11309-10 ¶167.

53 *Id.* at 11256 ¶24 (finding that "adoption of the modified embedded cost mechanism is consistent with our obligation to ensure that the support provided to rural carriers over the next five years is *specific, predictable, and sufficient*") (emphasis added).

54 *See infra* discussion in Section III.C.2.

Under the current system, efficiencies achieved by holding companies are reflected through lower support payments than would otherwise be required. If, for example, all the rural telephone holding companies divested their rural, high-cost exchanges, cost-per-line would likely increase dramatically for two reasons. First, under the Commission's current rules, support for corporate operating expenses[55] is limited,[56] and second, corporate operating expenses at the holding company level currently are spread over all commonly owned lines.

Basing support on state-wide or nation-wide costs would introduce a new layer of implicit subsidies within holding companies, contrary to the mandate of the Act.[57] Companies that did not divest their high-cost exchanges would end up subsidizing them from within. This clearly defies all the changes the FCC has made in the past decades -- and the 1996 Act's mandate -- to drive implicit subsidies out of ILEC rates.[58]

2. *Rural carriers already experience significant competition in their markets.*

Since the FCC modified the rural high-cost fund in 2001, competition in rural markets has continued to flourish. Proponents of forward-looking economic cost models claim that embedded cost models fail to provide accurate investment signals to potential competitors. To the contrary, available statistical data on rural competition underscores that the use of a forward-looking cost model is not necessary to achieve robust facilities-based competition.

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55 Overall administration and management providing accounting, financial, and legal services, procuring materials and supplies, and maintaining relations with government are examples of corporate operating expenses. 47 C.F.R. §36.631.

56 *Id.*

57 47 U.S.C §254 (e).

58 *MAG Order*, 16 FCC Rcd at 19617, ¶3 (noting the replacement of implicit subsidies with explicit support); *CALLS Order*, 15 FCC Rcd at 12974 ¶29 (removing the CCL charge from the rate structure and increasing the SLC caps).

Wireless providers and facilities-based CLECs clearly regard rural markets as ripe for competition.[59] The increasing number of CETCs receiving high-cost support alone demonstrates that there is significant rural competition.[60] Wireless carriers comprise over 96% of CETCs seeking high-cost support.[61] In Texas, CLECs have captured 12% of the state's local telecommunications market, but 16% of the local customers in rural areas.[62] Most notably, the Texas Public Utilities Commission found that CLEC competition is far more likely to be facilities-based in rural areas than in urban areas.[63]

This data is evidence that the current system for calculating high-cost support for rural carriers has substantial efficiencies already built into it and need not be changed at this time. Because of the fragility of rural markets,[64] any dramatic changes to the current cost-based

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59 *Section 706 Report* at 30 (reporting that high-speed lines to such areas grew from 37% of zip codes in June 2001 to 73% of zip codes in December 2003, evidencing dramatic growth in high-speed service to less populated zip codes).

60 *See* http://www.universalservice.org/hc/whatsnew/072004.asp#072704 (last visited on Oct. 4, 2004) (showing that the number of CETCs receiving high-cost support has climbed from 23 in 2001 to 142 in 2004; also showing that distribution of high-cost support to CETCs has grown from .78% in 2001 to 7.06% in 2Q 2004); Ex Parte Presentation of OPASTCO, "Universal Service in Rural America: A Congressional Mandate at Risk," Jan. 28, 2003 (charting the explosive growth of the universal service fund since 2001); Testimony of Bob Rowe, Chairman Montana Public Service Commission before the House Subcommittee on Telecommunications Hearing on "The Future of Universal Service," Sept. 24, 2003, at Illustration 6 (showing that the number of rural ILEC study areas with CETCs has grown from 72 in 3Q 2002 to 581 in 3Q 2003).

61 *See* USAC's Specific CETC High Cost Support Data, "*Distribution of HC Support between Wireless & Wireline CETC's*," at http://www.universalservice.org/hc/download/pdf/HC%20Wireless-Wireline%20CETC.pdf (last visited Oct. 13, 2004).

62 Report to the 78th Texas Legislature, *Scope of Competition in Telecommunications Markets in Texas*, Public Utility Commission of Texas (Jan. 2003) at xi.

63 *Id.* at 22-29.

64 *See supra* discussion in Section II.A.

system could have a devastating impact on rural carriers' ability to continue providing their customers high-quality services.

C. "Rural Telephone Company" Should Remain the Qualifying Entity for the "Rural High-Cost Fund."

1. *The "Rural Telephone Company" as defined in the Act is the appropriate standard for qualifying for high-cost support in rural areas.*

Section 254(b)(3) of the Act requires that consumers in "rural areas" have access to telecommunications services that are reasonably comparable to those provided in urban areas.[65] Currently, to determine which carriers serve "rural areas" for the purpose of Section 254(b)(3), the FCC uses the statutory definition of "rural telephone company."[66] Specifically, Section 153(37) provides that:

> The term "rural telephone company" means a local exchange carrier operating entity to the extent that such entity – (A) provides common carrier service to any local exchange carrier study area that does not include either – (i) any incorporated place of 10,000 inhabitants or more, or any part thereof, based on the most recently available population statistics of the Bureau of the Census; or (ii) any territory, incorporated or unincorporated, included in an urbanized area, as defined by the Bureau of the Census as of August 10, 1993; (B) provides telephone exchange service, including exchange access, to fewer than 50,000 access lines; (C) provides telephone exchange service to any local exchange carrier study area with fewer than 100,000 access lines; or (D) has less than 15 percent of its access lines in communities of more than 50,000 on the date of enactment of the Telecommunications Act of 1996.[67]

Since 1997, based on the recommendation of the Joint Board, the Commission has used the "rural telephone company" definition contained in the Act to distinguish between

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65 47 U.S.C. §254(b)(3).

66 *First Universal Service Report and Order*, 12 FCC Rcd at 8943-44, ¶310.

67 47 U.S.C. §153(37).

carriers serving rural and non-rural areas for the purpose of calculating rural high-cost support.[68] In 1999, although the Commission acknowledged that there is no statutory requirement to use the Act's definition of rural telephone company, it nevertheless decided to leave in place its prior decision to use the Act's definition of rural telephone company to distinguish between rural and non-rural areas for support purposes.[69]

ITTA opposes any change in the manner in which the Commission distinguishes between rural and non-rural areas because it would lead to significant uncertainty for rural carriers and the customers that they serve. The Joint Board does not need a crystal ball to predict what will happen to those properties that were served by carriers that formerly met the definition of rural telephone company but do not satisfy the new criteria. Many carriers faced this very scenario in the nineties when the FCC classified them as non-rural and began withdrawing their support.[70] Without sufficient universal service support, these exchanges simply will deteriorate because the carriers will lack any financial incentive to invest in them.[71] If they can find a buyer, they will sell them.[72]

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68 *First Universal Service Report and Order*, 12 FCC Rcd at 8943-44 ¶310. The Joint Board recommended that support for rural telephone companies be based on embedded costs because these companies generally serve fewer subscribers and do not benefit from economies of scale. *In the Matter of Federal-State Joint Board on Universal Service*, Recommended Decision, 12 FCC Rcd 87, 236 ¶287 (1996) ("*First Universal Service Recommended Decision*").

69 *In the Matter of Federal-State Joint Board on Universal Service; Forward-Looking Mechanism for High-Cost Support for Non-Rural LECs*, Tenth Report and Order, 14 FCC Rcd 20156, 20358 ¶458 (1999).

70 *See Reshaping Rural Telephone Markets: Financial Perspectives on Integrating Acquired Access Lines*, Legg Mason Telecom (Fall 2001) at 11-13.

71 *Id.* at 130-32.

72 *Id.* at 11-13.

Generally, this has been the case with high-cost properties sold by non-rural carriers. These lines have required considerable investment by the buyer -- independent rural telephone companies that purchase them. If the buyer does not receive sufficient high-cost support necessary to upgrade and maintain the newly acquired lines, they will not invest in them. Any change in the definition of rural carrier for the purpose of receiving high-cost support actually could result in a *less* efficient support mechanism, and significantly threaten the progress rural carriers have made in providing quality and universal service to high-cost areas at just, reasonable and affordable rates.

2. *Costs should continue to be measured at the rural telephone company's study area.*

The Commission currently measures rural carriers' costs on a study area basis.[73] In 1996, the Joint Board recommended that the Commission retain the current study areas of rural telephone companies as the service areas for CETCs, in part, because it would be an administrative burden for rural carriers to calculate costs "on a basis other than the study area level."[74] After having this rule in place for several years, the Joint Board now seeks comment on whether it should calculate high-cost support for rural carriers on some other basis.[75]

a. *Costs should not be measured at a "finer" level than the study area.*

To measure costs at a level more granular than the study area, such as the wire center, would be unduly burdensome for rural carriers. Records at this level of detail simply are unavailable because the FCC currently does not require carriers to measure any of their costs

73 47 C.F.R. §36.621.

74 *First Universal Service Recommended Decision*, 12 FCC Rcd at 179-80 ¶¶172-74.

75 Public Notice at ¶¶38-47.

below the study area level. It therefore would be very costly for carriers to create tracking and accounting systems necessary to begin keeping such data now. Such costs would be far from minimal and must be weighed in any effort to determine the overall efficiency of rural universal service support mechanisms. In addition, states typically do not require carriers to measure costs below the study area; the Joint Board should not recommend greater record-keeping burdens under the federal rules than are mandated under state rules.

b. *Costs should not be measured at a broader level than the study area.*

To measure costs at a broader level than the study area, such as the entire state or nation, also will not serve the public interest. As an initial matter, ITTA notes that adopting a policy to average rates and support across state-wide or nation-wide lines would disadvantage many rural customers by taking support away from carriers with multiple, diverse study areas. Under this approach, support may be high as to certain areas that do not require it, and low for areas that need it because support would be averaged across the entire state or nation. Moving to a state-wide or national measurement for support eligibility also would produce the irrational result that two areas with similar costs could receive entirely disparate levels of support depending solely on whether a holding company or a stand-alone ILEC served the area.

In addition, basing support on national or state-wide average costs would inject a new layer of implicit subsidies to ILEC rates, and all the evils that attend them. For instance, it would allow a competitor that does not serve the entire state to target only the most profitable areas within that state and receive high-cost support based on the ILEC's average per-line costs, even though the competitor's average costs may be lower than the ILEC's. This result would be inconsistent with the Commission's disaggregation policies. In the *RTF Order*, the Commission concluded that providing carriers with the option of disaggregating support would allow carriers the flexibility of matching the disaggregation and targeting methodology to their costs and geographic characteristics and the competitive and regulatory environment.[76] Any proposal to move to a state-wide or national measurement therefore would contradict and undermine the Commission's disaggregation policies.

Implicit subsidies violate Section 254(e) of the Act. Since 2000, the FCC has taken extraordinary measures to remove implicit subsidies from the universal service support system.[77] Moving to a system that bases costs at a broader level than the study area represents a dramatic shift in Commission policy and puts *implicit subsidies* back into the universal service support system, a result that the Act and the Commission clearly disfavors. As the FCC has recognized, implicit subsidies discourage efficient competition, limit consumer choice, and result in high-volume long-distance callers and urban residents paying artificially higher phone bills to subsidize and support universal service for others.[78]

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76 *RTF Order*, 16 FCC Rcd at 11302-03 ¶146.

77 *First Universal Service Report and Order*, 12 FCC Rcd at 8785-87 ¶¶13-17 (discussing the congressional mandate in the 1996 Act to remove implicit subsidies); *MAG Order*, 16 FCC Rcd at 19617 ¶3 (removing the CCL charge from the rate structure and increasing the SLC caps); *CALLS Order*, 15 FCC Rcd at 12974 ¶29 (removing the CCL charge from the rate structure and increasing the SLC caps).

78 *MAG Order*, 16 FCC Rcd at 19623 ¶18; *see also Texas Office of Public Utility Counsel v. FCC*, 265 F.3d 313, 318 (5th Cir. 2001).

IV. THE ADOPTION OF A FORWARD-LOOKING ECONOMIC COST MODEL WOULD CAUSE SIGNIFICANT DISRUPTION IN RURAL MARKETS, WITHOUT ANY GUARANTEE OF BENEFITS TO THE PUBLIC.

A. Rural High-Cost Support Should be Based on the Actual Costs of Providing Service Using Existing Network Designs -- not Hypothetical Ones.

In the Public Notice, the Joint Board asks whether it is now possible to develop a forward-looking cost model that would appropriately measure the costs of rural carriers.[79] ITTA believes the answer is no. In order to ensure that carriers receive sufficient support, consistent with Section 254(b) of the Act, the rural support mechanism should be based on a carrier's total network costs of providing service. Unlike the modified embedded cost mechanism that the Commission currently uses to calculate rural high-cost support, a forward-looking economic cost model does not properly reflect a carrier's actual costs. Instead, forward-looking models are based on the unrealistic assumption that a carrier has deployed the most-efficient technology operationally feasible and available in the marketplace.[80]

A forward-looking economic cost model is an inappropriate measure of rural carriers' costs because it penalizes rural carriers for not deploying the most-efficient technology available at any time. Under a forward-looking economic cost model, support is based on an idealized network or technology,[81] and is unlikely to bear any relationship to real carriers' existing operations. In contrast, basing support on historic costs allows carriers to be reimbursed accurately for costs they actually incurred in serving rural areas.

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79 Public Notice at ¶20.

80 *See In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Interconnection between Local Exchange Carriers and Commercial Mobile Radio Service Providers*, Report and Order, 15 FCC Rcd 15499, 15848-49 ¶685 (1996).

81 *First Universal Service Report and Order*, 12 FCC Rcd at 8899 ¶224; *see also First Recommended Decision*, 12 FCC Rcd at 230, ¶270.

The deployment of technology is a dynamic and ever-evolving process. Rural carriers' networks are deployed gradually over time and inevitably reflect a mix of both old and new facilities and technologies. It would be cost prohibitive for carriers to replace facilities every time a new, more efficient technology is deployed. Deployment of new technologies typically lags behind technology development. Technology that is considered the most efficient by today's standards will not be the most efficient tomorrow. Carriers simply cannot be expected to continually deploy the most efficient technology available. For this reason, while forward-looking costs may be relevant to an analysis of competitive build/buy decisions pertinent to the context of unbundled network elements ("UNEs"), they are irrelevant to ensuring carriers get "specific, predictable and sufficient" support for costs they actually incurred in rural areas. Rural high-cost support should continue to be based on costs for existing network designs -- not hypothetical operations.

B. <u>Developing a New Cost Basis for Support Would be Both Time-Consuming and Costly.</u>

1. *The Commission has never been able to identify a model that can reliably predict costs in rural markets.*

There is no "efficiency" in adopting a new cost model for rural markets. Since passage of the 1996 Act, the Commission has not been able to identify an "efficient" model for predicting rural carrier costs, nor has the Joint Board or the Rural Task Force. In 1996, after considering several proxy models, the Joint Board concluded that it could not recommend any of the proposed models as the basis for determining universal service support levels in rural high-cost areas.[82] The Joint Board concluded that the proposed models simply could not "precisely

[82] *Id.* at 234-35 ¶¶ 279-283.

model small, rural carriers' costs."[83] Concurring with the Joint Board's decision, the Commission found that the proposed mechanisms at that time did not predict "with sufficient accuracy" the cost of serving rural areas.[84]

More recently, the Rural Task Force also considered a number of alternative rural high-cost support mechanisms, including the forward-looking cost model used for non-rural carriers. Following careful consideration of the forward-looking cost model adopted for non-rural carriers, the Rural Task Force concluded that the model would not be an appropriate tool for determining the forward-looking costs of rural carriers.[85] Although the Commission noted in the *First Universal Service Report and Order* that a forward-looking economic cost methodology "*should* be able to predict rural carriers' forward-looking economic costs,"[86] neither the FCC nor the Joint Board has been able to develop a model for doing so.

2. *Because of the wide variability in costs in rural markets, there is unlikely to be any model that reliably can predict rural costs.*

The Joint Board and the FCC consistently have recognized that rural carriers face diverse circumstances and that "one size does not fit all" in considering the appropriate method for calculating universal service support for rural carriers. In 2001, consistent with the Rural Task Force's recommendation, the Commission rejected the use of a forward-looking high-cost

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83 *See First Universal Service Report and Order*, 12 FCC Rcd at 8934 ¶291.

84 *Id.* at 8935 ¶293.

85 *Rural Task Force Recommendation*, 16 FCC Rcd at A-17 - A-18. The hybrid cost proxy model, for example, produced cost estimates that "var[ied] widely from reasonable estimates of forward-looking costs." *Rural Task Force* Recommendation, 16 FCC Rcd at Appendix n.32.

86 *First Universal Service Report and Order*, 12 FCC Rcd at 8935 ¶293.

support mechanism for rural carriers through 2006.[87] While a forward-looking economic cost model may be sufficient for non-rural carriers, which have more homogeneous costs and larger service areas, the FCC concluded that it would be inappropriate for rural areas because of the significant diversity among rural carriers. The Commission noted that "rural carriers generally serve fewer subscribers, serve more sparsely populated areas, and generally do not benefit as much from economies of scale and scope."[88] As the FCC has acknowledged, "the cost of providing a local loop in a rural area may be approximately *one hundred times greater than the cost in an urban area*."[89]

The significant disparity between the cost of providing service to rural and non-rural areas has not changed since the Commission's adoption of the *RTF Order* in 2001.[90] Because of the diversity of the rural carrier community and the heterogeneity of their study areas, it would be difficult for the Commission to adopt a model that could reasonably predict costs for all rural carriers.[91] Any model based on "representative" rural costs necessarily will inject inefficiencies into an already efficient system.

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87 *RTF Order*, 16 FCC Rcd at 11256 ¶25.

88 *Id.* at 11253 ¶16.

89 *MAG Order*, 16 FCC Rcd 19613, 19636 ¶45 (emphasis added).

90 *In the Matter of Facilitating the Provision of Spectrum-Based Services to Rural Areas and Promoting Opportunities for Rural Telephone Companies to Provide Spectrum-Based Services*, Notice of Inquiry, 17 FCC Rcd 25554 (2002).

91 *See also* Rural Task Force, *The Rural Difference*, White Paper #2 (Jan. 2000) ("*Rural Task Force White Paper #2*"). The lack of homogeneity among rate-of-return carriers also was the reason that the Commission declined to impose price cap regulation on small and midsize carriers when it first adopted price cap regulation. *Policy and Rules Concerning Rates for Dominant Carriers*, Second Report and Order, 5 FCC Rcd 6786, 6818 ¶¶257-65 (1990) ("*LEC Price Cap Carrier Order*"), *aff'd sub nom. Nat'l Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993). Noting the differences among the

3. *The recent UNE proceeding provides additional evidence that forcing rural carriers to move to a forward-looking economic cost methodology would be an inefficient use of limited resources.*

Recent experience with the Commission's total element long-run incremental cost ("TELRIC") based rules for UNEs has been quite disappointing, very costly, and anything but predictable or efficient. After eight long years of expensive negotiation, arbitration and litigation, there remains significant debate regarding how TELRIC should be implemented so as not to discourage investment in networks. State proceedings on TELRIC-based rates have yielded widely divergent rates throughout the country and have resulted in many carriers being unable to recover a reasonable measure of their costs.[92] The FCC itself has initiated a new rulemaking to consider how to better clarify how TELRIC should have been implemented, noting among other things that many states failed to take into account actual variations in local market conditions.[93] Any new forward-looking economic cost methodology for universal service necessarily would involve additional complications and expenses for it would have to predict costs not only for UNEs but for all aspects of the rural ILEC's operations. This process would be very expensive and time-consuming to pursue, without any guarantee of benefits to the public. It also would fail to meet any standard of efficiency the Commission might employ in this proceeding.

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approximately 1400 LECs that existed at the time in the number and concentration of their access lines, the geographic location and dispersion as well as the significant financial and operational differences, the Commission concluded in the *LEC Price Cap Carrier Order* that such "vast differences among LECs caution against applying a single price cap plan to such a broad spectrum of companies." *LEC Price Cap Carrier Order*, 5 FCC Rcd at 6818 ¶257.

92 *See In the Matter of Review of the Commission's Rules Regarding the Pricing of Unbundled Network Elements and the Resale of Service by Incumbent Local Exchange Carriers*, 18 FCC Rcd 18945, 18948 ¶6 (2003) ("*TELRIC NPRM*").

93 *Id.*

4. *Use of a forward-looking cost methodology will not guarantee a reduction in the size of the fund.*

Proponents of a forward-looking cost model claim that it will reduce the size of the fund. This is not necessarily true. There is no guarantee that a forward-looking economic cost-based methodology would produce lower support payments than a historic-cost-based methodology. In fact, in some cases, use of a forward-looking model can even lead to *higher* support. For example, in a recent UNE case, the FCC acknowledged that Verizon's forward-looking cost model resulted in some cost estimates *above* the company's existing network costs.[94] Similarly, a hybrid cost proxy model ("HCPM") could produce forward-looking cost estimates at least comparable to embedded costs on a nation-wide basis.[95] Moving from an embedded cost model to a forward-looking cost model could be administratively burdensome and terribly disruptive to service in rural areas, *without reducing the size of the fund at all.*[96] Developing a high-cost support mechanism based on a forward-looking cost model would require the Commission and rural carriers to dedicate significant administrative resources without any assurance of resulting benefits to the public. It would be folly to embark on such an errand at this juncture.

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94 *See In the Matter of Petition of WorldCom, Inc. and AT&T Communications of Virginia, Inc. Pursuant to Section 252(e) of the Communications Act for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Verizon Virginia, Inc.*, DA 03-2738, CC Docket Nos. 00-218, 00-251, at ¶128 (rel. Aug. 29, 2003).

95 Dale Lehman, *Universal Service and the Myth of the Level Playing Field* (Aug. 12, 2003) at 14.

96 *Id.*

5. *Any forward-looking cost methodology would have a serious impact on investment in high-cost areas and would place rural operations at risk.*

Having concluded in 2001 that any mechanism designed to transition rural carriers to a forward-looking cost model would have to be fully analyzed and considered,[97] the Joint Board and the Commission should proceed cautiously. As noted above, any change in the manner in which high-cost support is calculated could have devastating consequences in rural communities.

ITTA has observed that the smaller study areas of most rural carriers make them far more vulnerable than non-rural carriers to financial harm from divergence between a model and their actual costs. The Commission itself noted in the *RTF Order* that "for many rural carriers, universal service support provides a large share of the carriers' revenues, and thus, any sudden change in the support mechanisms may disproportionately affect rural carrier' operations."[98] Similarly, in 1996 the Joint Board concluded that the proposed forward-looking economic cost models "could significantly change the support that [small, rural] carriers receive, providing funds at levels insufficient to continue operations or, at the other extreme, a financial windfall."[99]

As the Joint Board and the Commission recognized then and they must remain cognizant of today, rural carriers often are not poised to respond to changes in operating circumstances as quickly as large carriers.[100] A dramatic change in the manner in which rural high-cost support is determined could leave rural carriers with insufficient support to maintain

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97 *RTF Order*, 16 FCC Rcd at 11256 ¶25.

98 *Id.* at 11253 ¶16.

99 *First Universal Service Report and Order*, 12 FCC Rcd at 8934 ¶291.

100 *Id.* at 8934 ¶291.

current levels and quality of service. If the Commission decides to adopt a forward-looking economic model, the Commission should build in a transition period so that the services provided by rural carriers, and the customers they serve, are not placed at risk.

C. Existing Caps on Rural High-Cost Support Must be Reexamined.

The Joint Board seeks comment on whether support should be capped at the lesser of embedded or forward-looking costs.[101] ITTA maintains that current caps on universal service support should be lifted regardless of whether the Commission adopts a forward-looking economic cost or retains a cost-based methodology to calculate support. Currently, high-cost loop support is subject to an indexed cap which limits the growth in the total support available each year.[102] Ostensibly, the indexed cap and other high-cost caps are designed to prevent excessive growth of the fund. However, so long as support is "sufficient" and "predictable," as required by Section 254(b) of the Act, there is no statutory basis for limiting support to an individual carrier based on mere speculations that the support mechanism will result in an oversized fund.

Furthermore, caps have a detrimental impact on investment. If carriers are unable to recover some portion of their investment-related costs, they will lack any incentive to re-invest in their networks. As discussed in Section VI below, the most effective way for the Commission to limit the size of the fund is to require that CETCs receive support based on their own costs -- not the costs of the ILEC.[103]

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[101] Public Notice at ¶24.

[102] 47 C.F.R. §36.601(c).

[103] *See infra* discussion in Section VI.

V. SECTION 54.305 AND THE SAFETY VALVE MECHANISM SHOULD BE MODIFIED SO THAT INVESTMENT IN RURAL HIGH-COST AREAS IS NOT DISCOURAGED.

A. The Commission Should Eliminate Section 54.305(a) of the Commission's Rules.

Under the Commission's rules, a carrier that acquires exchanges from an unaffiliated carrier receives universal service support for those newly acquired lines at the same per-line support levels as the seller did prior to the transfer.[104] Section 54.305 was designed to prevent universal service support payments from unduly influencing carriers' decisions to purchase exchanges from other carriers.[105] The rule nevertheless has harmful consequences. Because support for non-rural carriers is averaged across a mixture of high-cost and low-cost lines, higher cost exchanges generally receive less support than is necessary to provide service to the customers residing in that area. By way of example, if a non-rural carrier sells its higher cost exchanges to a rural carrier, the support that the acquiring carrier receives will be frozen at the level previously provided to the non-rural carrier, pursuant to Section 54.305(a). Even with the adoption of the safety valve mechanism, support remains insufficient for acquiring carriers to invest in the newly acquired properties. The Joint Board has expressed concern that Section 54.305(a) has negative consequences.[106] Section 54.305(a) should be eliminated because it results in insufficient support for rural high-cost lines following a sale.

B. The Commission Should Revise Section 54.305(d).

The FCC's "safety valve" mechanism provides additional high-cost support to rural carriers that purchase high-cost exchanges and make post-acquisition investments to

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104 47 C.F.R. §54.305(a).

105 *First Universal Service Report and Order*, 12 FCC Rcd at 8942.

106 *In the Matter of Federal-State Joint Board on Universal Service*, Recommended Decision, 15 FCC Rcd 14714, 14723-24 ¶20 (2000).

improve the network infrastructure.[107] Specifically, Section 54.305(d) provides for up to 50 percent of any positive difference between the purchasing carrier's "index year" expense adjustment at the end of its first year of operations and subsequent year expense adjustment.[108] In a petition for reconsideration of the *RTF Order*, NTCA asked the Commission to amend Section 54.305 to allow acquiring carriers to receive safety valve support for first year investments in newly acquired exchanges.[109]

ITTA supports the goal of the safety valve mechanism because it allows carriers to recoup the costs associated with their investment. However, since its adoption, ITTA has observed that the rule's failure to permit carriers to receive support for first year investment discourages immediate post-acquisition investment -- precisely when there is the greatest pressure from customers and the state public utility commissions to invest. If a carrier purchases previously abandoned exchanges, the safety valve mechanism further disincents the new carrier from making any investments in the acquired exchanges until the second year of acquisition because the buyer will not receive support for any investments made in the first year. The Joint Board should support NTCA's request so that carriers may recoup part of their initial investment. Because the rule limits support to 50 percent of any positive difference between the purchasing carrier's index year expense adjustment at the end of its first year of operations and subsequent year expense adjustment, there is no risk that this modification will result in a windfall to acquiring carriers.

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107 *See RTF Order*, 16 FCC Rcd at 11282 ¶94.

108 47 C.F.R. §54.305(d).

109 NTCA Petition for Reconsideration (filed in CC Docket 96-45 on July 5, 2001).

VI. THE JOINT BOARD SHOULD RECOMMEND THAT CETCS RECEIVE SUPPORT BASED ON THEIR COSTS, NOT THOSE OF THE ILEC.

The Joint Board also seeks comment on the appropriate methodology for calculating support for ETCs in competitive study areas.[110] Under the FCC's current rules, a rural ILEC is eligible for high-cost support only if it demonstrates that its loop costs exceed 115% of the national average loop cost.[111] CETCs, on the other hand, are not required to demonstrate their costs or certify how they use support. Instead, they receive support based on what the rural ILEC receives.[112] The current support methodology presents a disconnect between a CETC's actual costs and the support it receives, and in some instances allows CETCs with low-cost loops to receive high-cost support. ITTA maintains that CETCs should not receive high-cost support unless they can demonstrate that their own costs justify it. Specifically, CETCs should be required to make a showing of costs based on their own facilities, and not those of the rural ILEC's.

The Joint Board recently recognized the impropriety of basing CETC support on ILEC's costs in a recommended decision submitted to the Commission in this proceeding. Specifically, the Joint Board stated,

> For areas served by rural carriers, we are concerned that funding a competitive ETC based on the incumbent LEC's embedded costs *may not be the most economically rational method for calculating support*. However, we do not yet have an adequate record to analyze and understand the consequences of recommending a change in the basis of support for areas served by rural carriers that face competition. We agree that universal service payments should not

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[110] Public Notice at ¶36.

[111] 47 C.F.R. §36.361.

[112] *First Universal Service Report and Order*, 12 FCC Rcd at 8933 ¶289.

> distort the development of nascent competitive markets. Universal service support should neither incent nor discourage competitive entry.[113]

ITTA maintains that the distribution of high-cost support to CETCs cannot continue to be based on ILEC costs as a proxy. Basing CETCs' support on their own costs would allow review of the level of support necessary to achieve the statutory mandate of "specific, predictable, and sufficient" support and would provide the appropriate incentives for CETC investment. Otherwise, the public gets no benefit from supporting the CETC. Responsible and efficient administration of the fund demands that the costs of CETCs be used to calculate the support they receive. The Joint Board will be assured that support is being used for the purpose for which it is intended only when CETCs and ILECs alike receive support based on their actual respective costs.

VII. CONCLUSION

For the reasons articulated above, ITTA urges the Joint Board not to recommend any changes to the manner in which ILEC support is calculated. The current rural high-cost support system provides specific, predictable, and sufficient support to rural carriers and has resulted in significant competitive entry. Furthermore, the current system already has built-in efficiencies and need not be changed at this time. The most effective way to make the system more efficient and to prevent further growth of the fund is to require that CETCs receive support based on their own costs.

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113 *Federal State Joint Board on Universal Service*, FCC 04J-1, CC Docket No. 96-45, Recommended Decision at ¶96 (rel. Feb. 27, 2004).

Respectfully submitted,
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